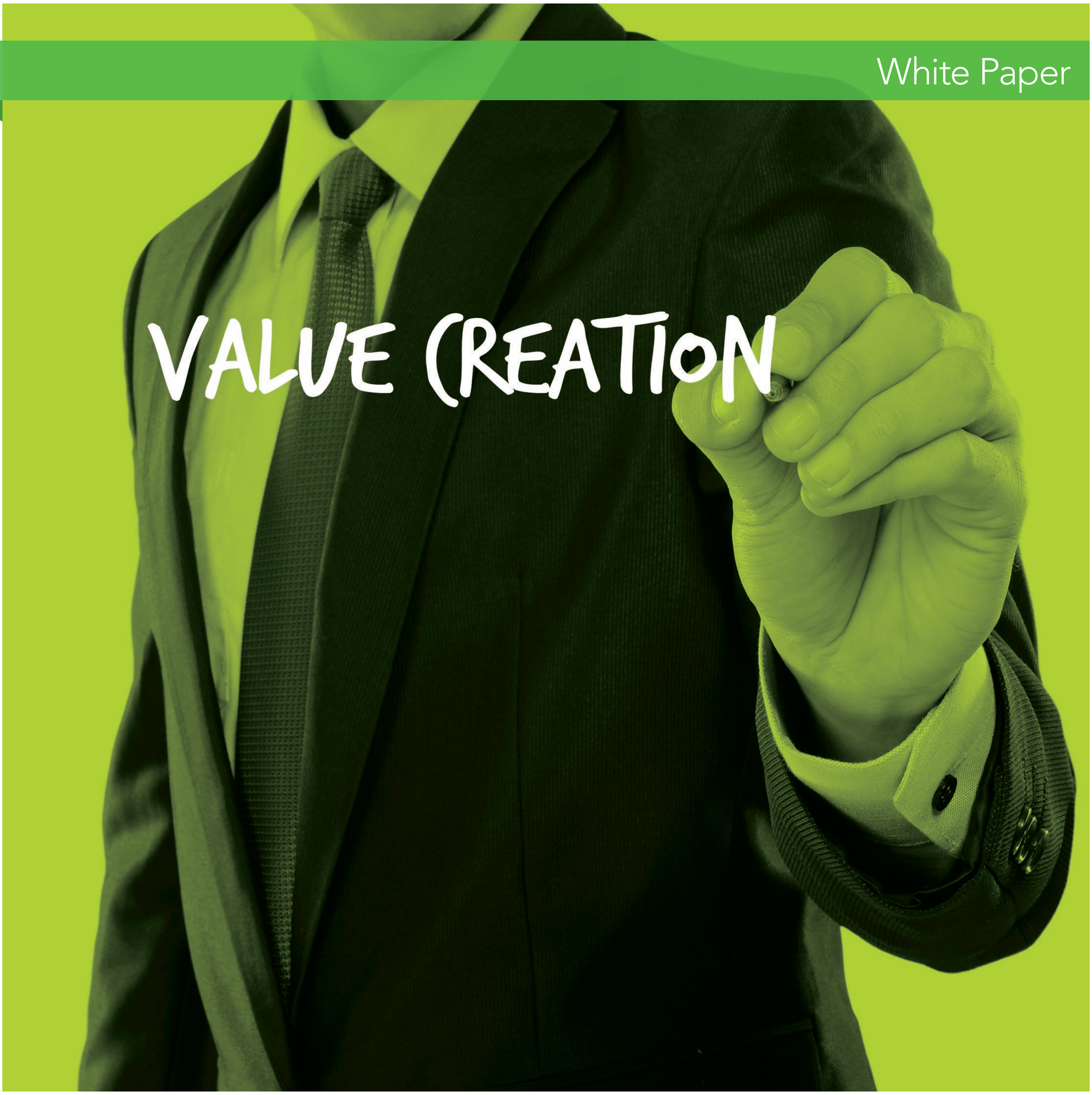
Value Creation

The Private Equity Lifecycle - Part 3

White Paper



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Introduction

The Private Equity Lifecycle series from Merrill DataSite is designed to keep you informed on trends and help you gain competitive advantage through each transactional stage. This chapter focuses on the key strategies that leading private equity firms are deploying to create value in their portfolio companies.

Getting Closer to the Target: A Key Element to Creating Value

In the past it was not uncommon for financial sponsors to rely on financial engineering to drive value in their target acquisitions. While this approach is still valid, it is no longer sufficient as a primary strategy for driving shareholder value. "Today's investors want to know exactly how a private equity firm plans to create value in its portfolio companies," said Toby Mitchenall, director of BackBay Communications, a strategic branding, marketing and public relations company serving the financial services sector. "General partners need to demonstrate a set of value creation skills that go beyond financial engineering."

Today, many leading private equity firms are driving their value creation strategies by becoming much more closely involved with their portfolio companies' operations. In support of this, over the past 10 years private equity firms have been steadily adding operating partners to their team. These partners' initial role was focussed largely on improving operations and controlling costs within the portfolio companies. "Private equity firms have become much more sophisticated in uncovering value in areas, such as supply chain management, over the past five years," said Dan Ginsberg, vice president and industry partner at Maine Pointe, an operational management consulting firm that works with private equity firms and their portfolio companies to create value by optimising their supply chains and operations.

"Whether a private equity firm is acquiring a company as an add-on to a platform or as a new investment, they're taking a close look at the target's supply chain because it's an area where value can be created by capitalising on cost inefficiencies and improving process effectiveness," he said. "When thoroughly understood, supply chains and operations are 'known' quantities that have proven to be good areas for generating rapid and sustainable financial returns."

Beyond improving operations and controlling costs of existing portfolio companies, private equity firms are also tapping into their operational partners' expertise early on,

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from the pre-acquisition stage onward. Recently, private equity deal teams and operational teams have started working in a more integrated, seamless manner throughout the entire life cycle of an investment—beginning in due diligence and continuing through exit planning. Jim Corey, founder of management consulting firm, Blue Ridge Partners, sees this more integrated approach between today's deal teams and operating teams happening as a natural means to support a full life cycle value creation plan being adopted by many private equity firms.

"It's a way to make sure that during due diligence you clearly define the value creation plan, implement it during the holding period and then, when you're ready to exit the investment, create an 'exit plan' that describes what the runway looks like for the next owner," Corey said, "because if you're going to sell the portfolio company to someone else, there has to be additional value creation possible for them. It's a full-cycle approach that includes refreshing the value creation plan for the next owner, because that is the way to optimise the value of the business."

Because the operating partner's role is becoming increasingly important pre- and post-acquisition, choosing the right partner for the private equity firm is critical. "Finding the right operating partner is not an easy process, because you're looking for an experienced, well-rounded executive who can move between diverse teams," said Ginsberg. "An effective operating partner is someone who can identify target opportunities, engage with the private equity management deal team and work with them to recognise revenue, cost, growth and other opportunities, and also work effectively with the portfolio companies' management teams." Good operating partners should also be able to tap into a network of specialists and consultants and bring them in as needed to assess potential investment targets or work with existing portfolio companies.

Four Components of Successful Value Creation

There is plenty of ground that can be covered in discussing the best ways to drive value from this full-cycle perspective – enough fodder to fill a book. With this in mind, the following pages discuss high priority areas, where private equity firms can accelerate growth and create value in their portfolio companies.

> A growing number of firms are adding functional and industry experts to their due diligence team.

1. Include Value Creation in the Due Diligence Process
In the past, risk mitigation was the primary focus of due diligence. Today, many M&A experts place equal importance on identifying value creation opportunities as part of the diligence exercise. Value creation diligence requires the buyer to have expertise in the target's industry, customer base, operations, sales models and other functional areas. To address this, a growing number of firms are adding functional and industry experts to their due diligence team.

Identifying a target company's value creation opportunities is only part of the due diligence exercise. The diligence process should also develop a 'plan to create value,' in which the acquirer can state explicitly why it intends to make an acquisition and how it intends to generate a return.[1] This approach lays a solid foundation for private equity firms to answer potential investors' detailed questions about their value creation strategies and expectations.

2. Have a Well-Defined Value Creation Plan
Value can be created in many ways, including revenue growth, cost reduction, balance sheet engineering and improving cash flow. However, for many private equity firms, the most important value creation strategy is to accelerate top line revenue growth. In their book "Threading the Needle: Value Creation in a Low-Growth Economy," Eric Olsen, Frank Plaschke and Daniel Steiter examined the sources of total shareholder return (TSR) among S&P 500 top-quartile performers over a five-year period and found a staggering 58 percent of TSR was generated through revenue growth. [2]

In Corey's experience, the private equity firms that are clearly outstanding at driving value creation employ a methodical approach that typically starts before the letter of intent (LOI) and goes all the way through to the point of exit. "One private equity firm we work with starts by creating a single sheet, a waterfall chart that describes how they're going to take the target from its current valuation to three times that valuation. What are the building blocks that have to fit in between 1X and 3X? That becomes the foundation of their value creation plan. They know specifically what they're trying to get done and they create the metrics to assess their progress against each of those elements intended to drive growth."

For most companies, driving top line revenue is far from a simple task – and one which often requires both an audit of the company's internal processes, such as their sales operations, and external factors, such as the company's understanding of its customer base. This is followed by a step-by-step action plan in which the private equity firm can help identify and act on the top handful of action items that will create the greatest value.

Private equity firms may have the resources in place to help their portfolio companies go through this planning process. Many successful firms, however, hire management companies, like Blue Ridge, whose services are focused on helping clients evaluate their organisations and make improvements to accelerate top line revenue growth. This has proven invaluable in helping firms identify issues, such as weak operational links and sales 'myths' that are preventing the portfolio company from accelerating growth.

Private equity firms must also be cognisant of external factors taking place today that represent very real challenges to sales growth. One phenomenon affecting virtually every company selling products is the reality of today's well-informed buyers, who, as a result of the Internet and instant access to information, are far more self-educating than they have ever been.

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1. William J. Gole and Paul J. Hilger, "Due Diligence: An M&A Value Creation Approach," Wiley & Sons, Hoboken, NJ, 2009. P. 17.
2. "How to Grow a Business: Insights from Working with Over 300 Companies," Blue Ridge Partners Management Consulting, LLC.

Research shows that up to 60 to 70 percent of decision-making in the business-to-business marketplace [B2B] is made before the decision-maker approaches the supplier. SiriusDecisions reports that 70 percent of the buying process in a complex sale is already complete before prospects are willing to engage with a live salesperson[3]. With such sea changes transforming the buying process, private equity firms must be prepared to help their portfolio companies adjust sales strategy to fit today's realities.

3. Build Organisational Performance into the Value Creation Process

Much has been written about the importance of identifying and retaining key talent when acquiring a company. Yet, this aspect of value creation has become more important and more challenging than ever, according to Andros Payne, CEO of Humatica, a specialist advisory firm that helps investors enhance their returns by improving the performance of their portfolio company organisations.

In Payne's view, the rate at which the world is changing, whether as a result of economic, technologic or other drivers, is forcing companies to respond at a much faster pace if they want to stay ahead. "Success is really driven by the collective ability of an organisation to act quickly and adapt," he said. "This is driven by the quality of the interactions between the white-collar employees to collectively recognise emerging patterns at all levels, faster than the competitors' organisation."

It is also driven by a portfolio company's ability to retain key employees who can drive an adaptive culture and deliver successful results. Yet the danger for private equity firms as acquirers is that key employees often leave if they do not see a positive future for themselves post-acquisition. Moreover, traditional management models are less effective in retaining employees. "Today's employees are not dependent on a company and its physical assets for their own career development and their behaviour cannot be influenced through authoritarian control," said Payne. "In fact, the most creative people – sales people, product developers and marketing people – respond quite negatively to authoritarian control and leave."

His firm conducts a five-step process to help private equity firms identify key talent and assess a target company's organisational agility as the means to drive value. Where other experts may take a psychological approach to assessing human capital, Payne has helped his clients accelerate growth by taking a quantitative approach to identify key behaviours that drive the ability to adapt and/or gaps, benchmark them and develop a plan to increase value. "Our approach is to de-mystify this by breaking down culture into specific behavioural patterns and identify those that drive the collective ability to change, to adapt, to make and execute good decisions," he said. "This is the core that increasingly drives value creation."

4. Invest in Marketing and Public Relations to Build Value

Today's leading private equity firms have also identified the value of branding and public relations (PR) as a means to increase their portfolio companies' value. According to Mitchenall of BackBay Communications, financial sponsors increasingly realise that refining and shaping a portfolio company's brand and raising awareness of the business among certain target audiences are vital ways to build value.

"There are two reasons why private equity firms engage us to work with portfolio companies," Mitchenall said. "The first is to feed into the marketing strategy and help grow the company's top line by driving sales; by shaping the company's brand and raising its profile among its client or customer base."

The second reason private equity firms are increasingly using PR is to communicate the portfolio company's success and, by extension, build its value to potential buyers and intermediaries. A PR firm can be very effective in reaching the wider business and finance community, and promoting stories of the company's growth, its values, the strength of the management team and its attitude to corporate responsibility. "Reputation, in the form of goodwill, has financial value. Growing and enhancing reputation is, therefore, one of the value creation levers at the disposal of a financial sponsor," said Mitchenall.

> "…the collective ability to change, to adapt, to make and execute good decisions…This is the core that increasingly drives value creation."

3. Torben Rick, "The Future of B2B Marketing – Fasten Your Seat Belts," Meliorate blog post: www. torbenrick.eu. April 21, 2014.

The Foundation of a PR Strategy for Value Creation

All portfolio companies have different needs, but a good PR and branding strategy to create value should include the following elements:

- **Brand research and refreshment:** A vital first step is to thoroughly research and understand what the company's brand stands for, including its strengths and weaknesses. This forms the basis to develop brand values, messaging and market positioning, which should flow consistently through all communications activities.
- **Develop a marketing and communications programme:** The plan should include clearly defined deliverables that support the business plan. This will vary hugely depending on what sort of company it is, but should always be tied back to the business plan.
- **Develop a profiling programme:** The goal here is to elevate and enhance the management team's standing and the corporate reputation of the business.
- **Review and reinforce internal and external communications processes:** These include media training and crisis management plans. Building a reputation is a hard-won process – and it is easily undone by a badly handled crisis.

Investing in a PR strategy and working with a PR firm with industry experience can yield stellar results, as the following case study by BackBay Communications illustrates:

Case study

PR firm BackBay Communications announced a growth capital investment by one of its longstanding private equity clients in a financial technology (fintech) company. BackBay subsequently took the CEO of the company, along with a partner from the private equity firm, on a media tour to meet journalists and discuss the rationale for the investment. The messages included the favourable market conditions for the fintech company's growth and key elements of management's growth strategy.

As the next step, the BackBay team conducted research and developed messaging for the fintech company. It developed a marketing plan including public relations, awards, analyst relations, conference speaking and advertising. After three years of successfully executing the plan, the business was sold to a major investment banking group. At the time of the sale, an analyst writing about the transaction said the fintech's brand was one of the primary reasons for its high valuation.

Summary

Today's private equity firms must be prepared to invest in a multi-dimensional approach to value creation if they are going to achieve their valuation goals and appeal to today's sophisticated investors. Beyond assessing a portfolio company's internal value creation opportunities, financial sponsors must understand external value creation – when, where and how to build value for their portfolio in the marketplace. The most successful firms know when to draw on their internal resources and when to draw on outside expertise to build out the value creation strategy.

Where to begin? As experienced private equity firms know, the process of identifying opportunities for value creation for a portfolio company can yield a long list of areas for improvement. Leading firms prioritise their efforts by objectively assessing opportunities based on the value they can deliver. As Corey of Blue Ridge Partners noted, "The key is to identify the top three or four opportunities that can actually drive value and focus on executing exceptionally well in those areas. Firms that focus in this manner are more likely to achieve their valuation targets."

Leverage Technology to Streamline and Enhance the Value Creation Process

Fund managers continue to invest in technology to improve portfolio management. Tools, such as data analytics, are increasingly being adopted by private equity firms and Corporates to identify targets and "predict" their performance versus competitive players. Virtual data room (VDR) technology is used by private equity firms to gather portfolio company information, collect and publish performance reporting and make it more accessible to private equity firm management, regardless of location.

A top-quality VDR platform can be a command centre to support every stage of a portfolio company's life cycle, from pre-acquisition due diligence to post-acquisition performance monitoring and its eventual presentation to potential buyers. Perhaps most importantly, today's Internet-based VDRs have given private equity firms a secure platform to market from and exchange intelligence all over the world.

To learn more about the Merrill DataSite VDR, email info@datasite.com or call us on +44 (0)845 602 6916.

"Difference Makers" that Drive Value in Portfolio Companies

Is there a standard "checklist" of company traits that private equity firms can use to identify portfolio companies that will create value that meet their investment criteria? According to Jim Corey of Blue Ridge Partners, there is a common set of traits that can help inform private equity firms' decisions.

"We looked at all 300 companies we've worked with during the last 12 years and created a list of "difference makers," or those things that really produced value for our clients," Corey said. "There was an amazing commonality across these companies within a given business model." For example, in business-to-business (B2B) selling environments, these companies:

- ☑ **a.** Segment the market based on buyer values and decision making factors rather than customer size and industry alone—this approach to segmentation helps salespeople focus their efforts on the highest potential prospects and helps them understand how to vary their sales messages.
- ☑ **b.** Find ways to generate high-quality new leads—the "hunting" skills in many companies have been lost or are being sub-optimised by time spent on non-selling activities.
- ☑ **c.** Understand "share of wallet"—the amount of the customer's total spending they are actually capturing and figure out what business they are missing. According to Corey, the company's share of wallet is almost always lower than the sales team believe—this means there are selling opportunities being overlooked.
- ☑ **d.** Optimise the value of the long tail of small customers. Most companies are unable to economically serve large numbers of smaller customers through their direct sales team. More cost-effective models exist for serving these smaller customers—telesales, online, distributors, manufacturers reps and other channels.
- ☑ **e.** Convert from a "self-directed" sales organisation to a "company-directed" sales organisation. Most companies fail to give sufficient guidance to salespeople on how to allocate their time; how to establish a productive cadence of weekly activities; which prospects represent the best opportunity for the company; and what level of activity is required to produce the targeted revenue. This necessitates better supervisor coaching, better sales processes and compensation plans that are better aligned with company expectations.
- ☑ **f.** Focus on the core business if profitable growth opportunities remain—for most businesses, the core represents their most important customers and products. Many companies dilute management attention and capital across too many customers and too many products.
- ☑ **g.** Optimise their pricing, so margins are not left of the table (pricing too low) or unnecessary customer losses (pricing too high).
- ☑ **h.** Improve the retention of profitable customers through early warning systems, save teams, early renewals and other techniques.

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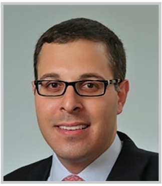
Toby Mitchenall,
Director of BackBay Communications



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About Merrill DataSite

Merrill DataSite is a secure virtual data room (VDR) solution that optimises the due diligence process by providing a highly efficient and secure method for sharing key business information between multiple parties. Merrill DataSite provides unlimited access for users worldwide, as well as real-time activity reports, site-wide search at the document level, enhanced communications through the Q&A feature and superior project management service—all of which help reduce transaction time and expense. Merrill DataSite's multilingual support staff is available from anywhere in the world, 24/7, and can have your VDR up and running with thousands of pages loaded within 24 hours or less.

With its deep roots in transaction and compliance services, Merrill has a cultural, organisation-wide discipline in the management and processing of confidential content. Merrill DataSite was the first VDR provider to understand customer and industry needs by earning an ISO 27001 certificate of registration—the highest standard for information security—and is currently the world's only VDR certified for operations in the United States, Europe and Asia. Merrill DataSite's ISO certification is available for review at www.datasite.com/security.htm.

As the leading provider of VDR solutions, Merrill DataSite has empowered more than two million unique visitors to perform electronic due diligence on thousands of transactions totalling trillions of dollars in asset value. Merrill DataSite VDR solution has become an essential tool in an efficient and legally defensible process for completing multiple types of financial transactions.

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